Risk Management Practices in Islamic Bank: A Case Study of Islami Bank Bangladesh Limited

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Abstract

Islamic banking industry has been growing rapidly for last three decades. As risk is inherent in banking business it is necessary to develop a comprehensive risk management framework and process. In this paper, a humble attempt has been made to study and analyze risk management practices of Islami Bank Bangladesh Limited (IBBL), one of the leading Islamic banks in Bangaladesh. Annual reports of IBBL and 7 other full-fledged Islamic banks, Bangladesh Bank, the central bank of Bangladesh, publications and guidelines on risk management, secondary data collected from various published papers and Datastream are used to analyze and support the findings of the study. It is found that the bank has developed an extensive risk management framework and process. The bank is found to be moderate to low risk taker in terms of investment exposures. The bank has been generating sustainable earnings from its depositors fund but lower return on shareholder's fund due to lack of *shari'ah* compliant financial instruments in Bangladesh. Even though the bank mobilizes funds on profit and loss sharing principle, but study indicates that all risks are actually borne by the bank e.g., financing impairment is charged to shareholders only like conventional banks. Physical assets constitute a significant portion of the bank's balance sheet and evidently these assets are funded by shareholders fund. Currently, the bank does not use any derivative instruments as they are not available in the financial market of Bangladesh. Income gap analysis of the bank shows that its rate sensitive assets are higher than rate sensitive liabilities which seem unfavorable in decreasing interest rate environment, consequently, bank's profitability declined over the year. In spite of that, the spread between funding cost and financing income is above 5%. It can be argued that the inclination towards *murabaha* financing is evident from the analysis and 72% of the exposure of the Bank lies under the Risk weight category of 50% or below, which is considered to be one of the significant strengths of IBBL. Moreover, displaced commercial risk and excess liquidity risk tend to affect significantly the bank's efficiency and profitability.

Key words: *risk management, investment risk, liquidity risk, Islamic bank, Islami Bank Bangladesh Ltd*

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Introduction

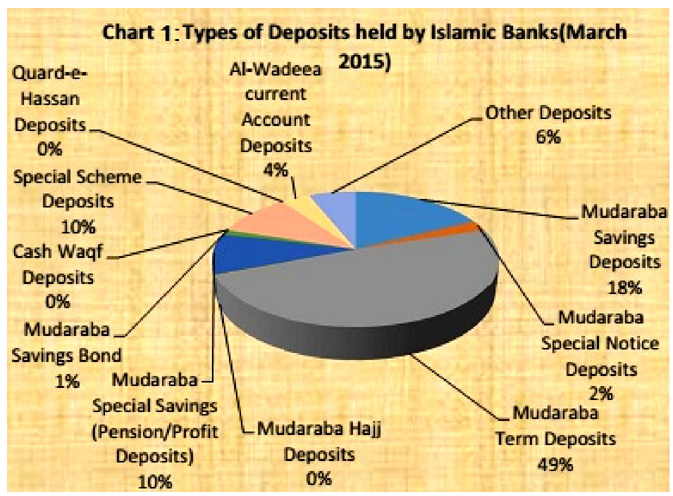
Islamic finance has been thriving for last two decades mainly due to phenomenal growth of Islamic banking industry. Islamic banking has opened up a window of opportunity for those Muslims who are eager to participate in interest-free and *Shari'ah* complaint banking system, in absence of which most of them wouldn't have involved at all. In addition, international financial systems get benefit from diversified financial products and operations, available in Islamic banks, which are characterized by distinct risk-sharing features for each type of contract (**Iqbal and Llewellyn, 2002**).

Banking industry is one of the most highly regulated industries in the world. Risks, financial and non-financial, are inherent for banks, financial intermediaries, which mobilize fund from surplus unit to deficit unit of an economy. Financial risks consist of market risk and credit risk, whereas non-financial risk include, but are not limited to operational risk, regulatory risk and legal risk (**Khan and Ahmed, 2001**). Islamic banks, an integral part of a financial system, are not excluded from these risks. The establishment of the Islamic Finance Standard Board's (IFSB) guiding principles on Risk Management in 2005 reflects the growing importance of prudent risk management in Islamic banking industry. Consequently, the survival and success of Islamic banks depend on the efficiency in which they can manage risk, and thus, effective risk management is critical for maximizing shareholders wealth (**Akkizidis and Khandelwal, 2008**).

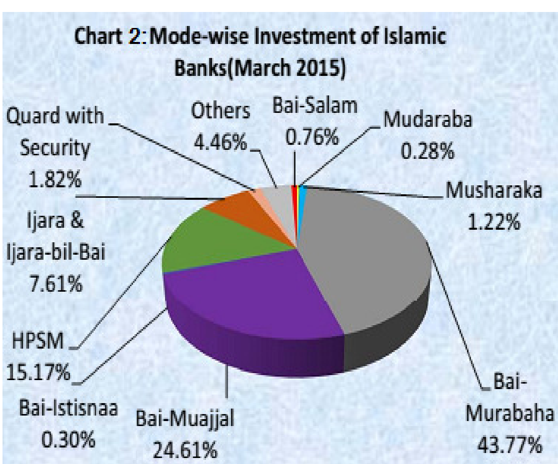
A brief overview of Islamic Banking industry in Bangladesh

Islamic Banking Industry has been playing a crucial role in mobilizing deposits and financing key sectors of the economy in Bangladesh since its inception in 1983. At present Islamic banking industry is comprised of 8 full-fledged Islamic banks, 19 Islamic banking branches of 9 conventional commercial banks and 25 Islamic banking windows of 7 conventional commercial banks are also providing Islamic banking services in Bangladesh (**Bangladesh Bank, 2015**).

Islamic Banking Industry accounted for more than one-fifth share of the entire banking industry in terms of deposits and investments. Total deposits in Islamic banking industry reached BDT 1467.34 Bln or USD 18.72 Bln (USD 1=78.4 BDT) at the end of January-March 2015 quarter, which increased by BDT 25840.78 million or by 1.79% compared to previous quarter and by BDT 201410.21 million or by 15.91% compared to corresponding quarter of the last year. Total investments in Islamic banking sector stood at BDT 1267.05 Bln or USD 16.16 Bln (USD 1=78.4 BDT) at the end of January-March 2015 quarter, which went up by BDT 27540.68 million or by 2.22% and by BDT 191050.02 million or by 17.76% compared to previous quarter and same quarter of the preceding year respectively (**Bangladesh Bank, 2015**).



Among different types of deposits of the Islamic Banking industry, *Mudaraba* Term Deposits secured the highest position (49%) [chart-1] followed by *Mudaraba* Savings Deposits (MSD) (18%), *Mudaraba* Special Savings pension/profit) Deposits (10%), Special Scheme Deposit (10%), Other deposits(6%), Current Account Deposits (4%), *Mudaraba* Special Notice Deposits(2%), *Mudaraba* Savings Bond (1%) etc (**Bangladesh Bank, 2015**).



The highest investments was made through Bai-Murabaha mode (43.77%) at the end of the quarter January-March 2015, [chart-2] followed by Bai-Muajjal (24.61%), HPSM (15.17%), Ijara & Ijara-bil-Bai (7.61%), others (4.46%), Quard with Security (1.82%), Musharaka (1.22%), Bai-Salam(0.76%), Bai-Istisna (0.30%) and *Mudaraba* (0.28%) (**Bangladesh Bank, 2015**).

Islami Bank Bangladesh Limited (IBBL)

Islami Bank Bangladesh Limited, is the leading Islamic bank in Bangladesh established in 1983, is a Joint Venture Public Limited Company engaged in commercial banking business based on Islamic *Shari'ah* with 63.09% foreign shareholding having the largest branch network (total 301 Branches) among the private sector Banks in Bangladesh. It was established on the 13th March 1983 as the first Islamic Bank in the South East Asia. The total assets of the bank is USD 7.1 Bln, which is 39.29% of total Islamic banks deposit and Investment of USD 7.2 Bln, which is 38.04% of the total Islamic banks investment.

Financial Information: *[As on: 31 December 2014]*

	BDT (Million)	USD (Million)*
Authorized Capital	20,000.00	255.10
Paid-up Capital	16,099.90	205.36
Equity	48,569.86	619.51
Reserve Fund	28,097.92	358.92
Deposits	560,696.30	7151.74
Investment (including Investment in Shares)	564,332.00	7198.11
Foreign Exchange Business	**BDT (Million)**	**USD (Million)**
Import	316,970.00	4042.98
Export	222,753.00	2841.24
Remittance	308,722.00	3937.78

* Authors calculations based on (1 USD = 78.4 BDT)

Organizational Information:	
Chairman, Board of Director	**Engr. Mustafa Anwar**
Managing Director & CEO	Mohammad Abdul Mannan
Company Secretary	Abu Reza Md. Yeahia
CFO	Mohammed Shahid Ullah
Number of Zones	15
Number of Branches	301
Number of AD Branches	52
Number of ATM Booth	410
Number of Shareholders	33,686
Number of Manpower	11,381

What is Risk management?

It is the overall process that a financial institution follows to define a business strategy, to identify the risks to which it is exposed, to quantify those risks, and to understand and control the nature of risks it faces (**Cumming and Hirtle, 2001:3**).

Risk management is invoked to ensure that banking operations undergo a process of risk identification, risk measurement and risk mitigation in their financial offerings (**Rosly, 2014**).

Fundamentals of the risk management process comprise of three main features: i) establishing an appropriate risk management environment, sound policies, and procedures ii) maintaining an appropriate risk measurement, mitigating, and monitoring process, and iii) adequate internal controls (**Khan and Ahmed, 2001**).

Risk management in Islamic banks incorporates risk measurement, risk management and risk control (**Iqbal and Mirkahor, 2007**). Islamic banks face many unique risks due to the nature of their operations, particularly *Shari'ah* compliance requirements (**Rosman and Rahman, 2014**).

From the above definitions, we can conclude that risk management is a process to identify, measure, mitigate and monitor risks. In addition to that, an integrated framework and a day-to-day risk communication throughout the different operating levels are the foundation for a best practice risk management process (**Salem, 2013:9**)

Risk management process and risk management framework

Risk management process refers to the steps underlying any risk management system, which are risk identification, assessment and mitigation. In other words, it is the process of anticipating and analyzing risks and coming up with effective and efficient ways of managing as well as removing or mitigating them.

On other hand, risk management framework implies a broader view of the risk management system in which both economic (ex post and ex ante) and regulatory analysis are engaged. The risk management process in applied for each phase of analysis, economic and regulatory, within the framework. To further elaborate, it provides the basic infrastructure to deal with the risk in the banking business. It allows the risk management process to be conducted with a view of balancing risk and reward strategy of the bank. The identification, measurement and control of risk in the extension of financing facilities will ensure that risk management objectives are fulfilled, thus ensuring safety in the use of deposit funds. In the following diagram risk management process is shown under a comprehensive risk management framework (**Salem, 2013**).

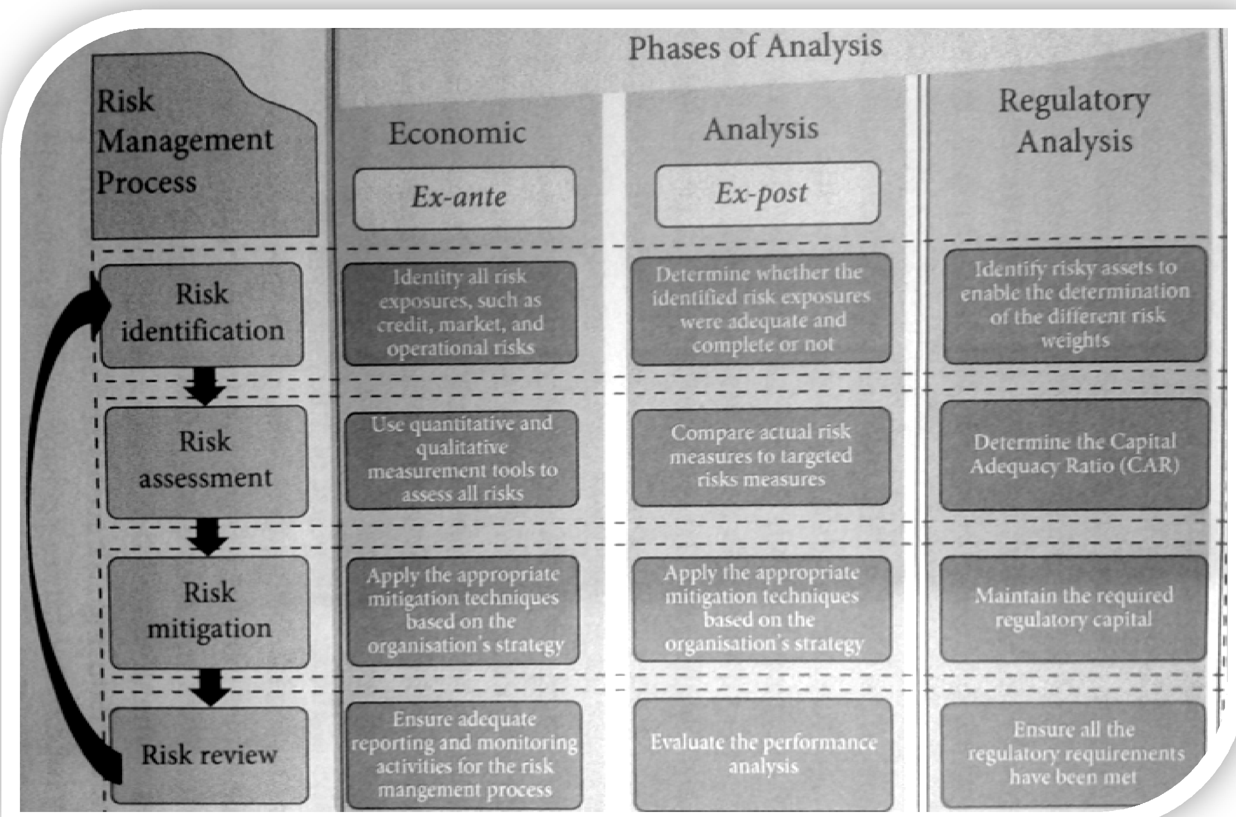


Figure 1: Risk Management Framework

Source: Salem (2013), p.11

Risk Management Framework and Process in IBBL

As a *Shari'ah* based bank, IBBLs risks are mainly mitigated by observing *Shari'ah* rules and regulations. The bank has its own risk management philosophy for giving proper attention to risk management. Based on its philosophy and guideline from the Bangladesh Bank, the central bank of Bangladesh, IBBL has established a comprehensive risk management framework which is highlighted in the following diagram.

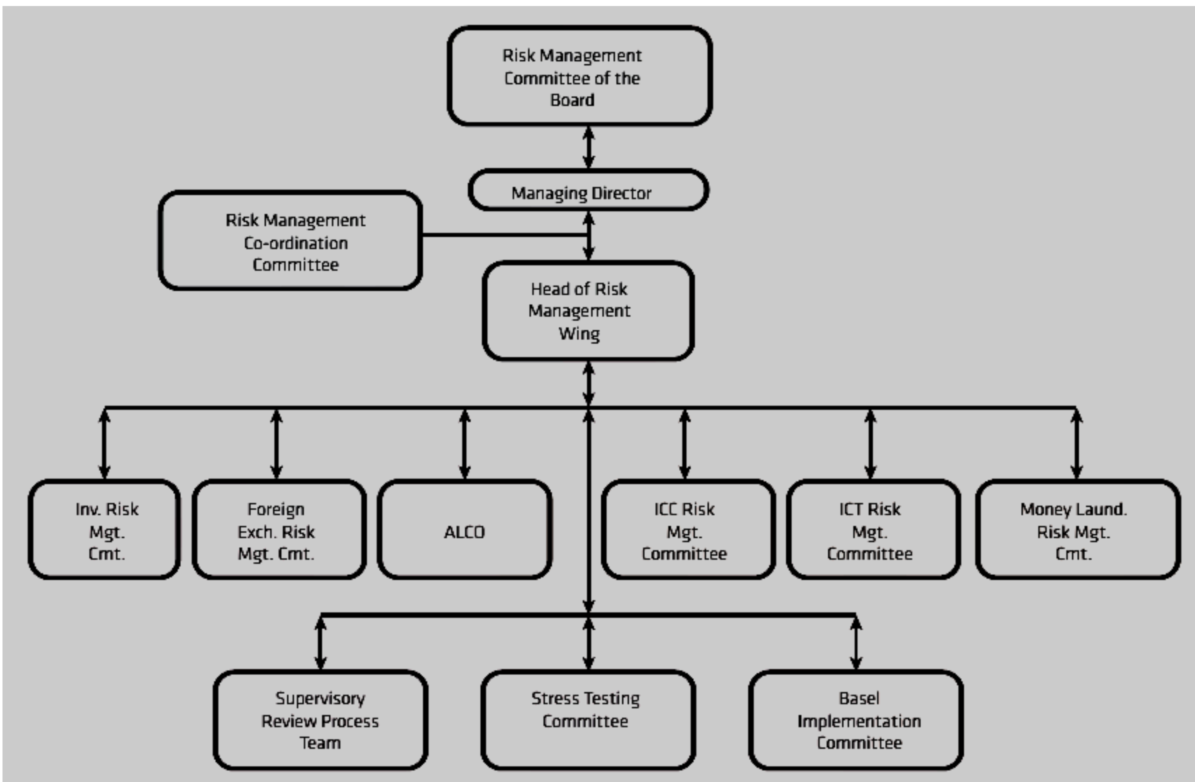


Figure 2: IBBL Risk Management Framework (Source: Annual Report 2014)

The Risk Management process, as shown in the following diagram, is segregated into five steps: establishing the context, risk identification, risk analysis, risk evaluation and risk treatment. From the each steps of the risk management process, there is sufficient option for communication, consultation, reporting, monitoring, and review system.

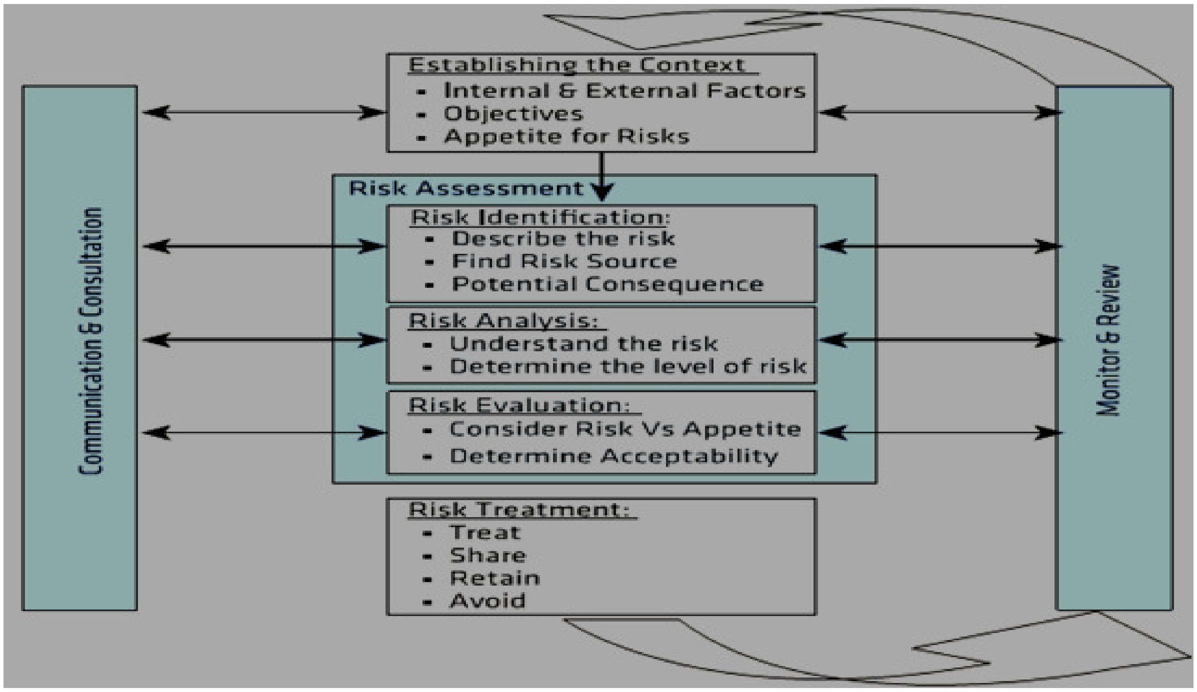


Figure 3: IBBL Risk Management Process (Source: Annual Report 2014)

Risk appetite and risk governance

Risk appetite is the amount of risk an organization is prepared to tolerate (or be exposed to) at any given point in time. It is a measure of the propensity for risk taking. It is driven by many factors such as capital, human resource, the business climate, regulations and global financial markets. However, it is argued that risk-appetite is also influenced by one's value system. Bank's directors are responsible to define the risk appetite acceptable to the business from the business model and strategy adopted by them. In other words, risk appetite is the degree of risk, on a broad-based level, that the bank is willing to accept in pursuit of its goals. Risk appetite is set first in evaluating strategic alternatives, then in setting objectives aligned with the selected strategy and in developing mechanisms to manage the related risk.

Risk governance is a three layer arrangement of an entity to carry out the risk management process effectively and efficiently throughout the organization. These three line of defence are shown in the following figure (Figure 4). Risk governance focuses on applying the principles of sound corporate governance to the assessment and management of risks to ensure that risk taking activities are aligned with an institution's capacity to absorb losses and its long-term viability. It is concerned in particular with the roles of the board, senior management, and risk management control functions as well as the processes by which risk information is collected, analyzed and communicated to provide a sound basis for management decisions. It is also concerned with the effects of incentives and organizational culture on risk-taking behaviors and perceptions of risk in the institution. With increasingly complex business operations and activities, the availability of comprehensive and integrated systems to support an enterprise-wide or consolidated view of risks, for both the individual financial institution and for the group, is particularly critical. Also important is the capacity of institutions to respond swiftly to changes in the operating environment and developments in the institution's business strategies. (**BNM, 2013**)

Three Lines of Defense

1st Line of Defense	2nd Line of Defense	3rd Line of Defense
Day to day Risk Management & Management Control	Risk Oversight Policy & Methodology	Independent Assurance
Business Units	• Board's Risk Management Committee	• Audit Committee
Support Functions	• Chief Risk Officer	• Internal Audit
	• Risk Management Wing	• External Audit • Supervision of Regulators
	• Operational Risk Management Committee	

Figure 4: Risk Governance in IBBL

The risk management framework of IBBL (Figure 2) shows that the Board is responsible for approving risk appetite, the level of risk the bank choose to take, in pursuit of its business objectives. The following table shows the extract of balance sheet composition of types of financing against total assets which would give us a better picture of overall risk appetite of the bank.

Table 1: Measuring risk appetite from the bank's balance sheet

	2014	**2013**
Outstanding against Corporate /Total Assets	48.19%	51.82%
Unrated Corporate/Total Assets	4.33%	3.60%

Source: Annual Report 2014

By looking at the table 1, we can assume the bank's risk appetite. In this case, the bank has moderate to low risk appetite as 48.19% of its total assets are invested in rated corporations compare to only 4.33% in unrated corporations. In addition to that, if we look at the following table on types of assets, it would be clearer that, the bank tends to be quite risk neutral. It appears rational, bank invest its depositors fund, so they cannot take excessive risks by investing in ventures like *mudaraba* or *musharaka* since assets classes such as *musharaka* and *mudaraba* are needed higher capital charge as per regulatory requirements. However, this risk averse attitude of an Islamic bank, like IBBL, creates doubt in intellectual mind the whole purpose of banking in Shari'ah compliant way and uphold *maqasid al-shari'ah.*

Table 2: Mode wise investment of IBBL

	2014	% of Total Assets
Bai-Murabaha	2,53,916.69	**54.79**
Bai-Muajjal	29,797.76	6.43
Hire Purchase under Shirkatul Melk	1,03,940.76	**22.43**
Bai-Murabaha Import Bills	5,861.48	1.26
Bai FC Bills	9,498.99	2.05
Musharaka	484.38	0.10
***Mudaraba* Investment**	3,000.00	0.65
Bai -Salam	4,807.60	1.04
Murabaha Foreign Currency Investment	6,952.88	1.50
Quard	15,478.09	3.34
Investment in Khidmah Card	16.99	0.00
Overseas Investment (outside of Bangladesh)	2,338.48	0.50
Bills Purchased and Discounted	27,381.37	5.91
Total	4,63,475.47	100.00

As IBBL's risk appetite is evident from the above discussion, moreover, in order to identify, measure, manage and mitigate risks it has developed its own risk governance framework based on risk appetite of the bank. The bank has active risk management and coordination committee at the top of the framework (figure 2) to look after the overall risk management of the bank. IBBL has developed risk management culture starting from relationship officer at the branch level to the head of risk management wing.

Financial scoreboard

The bank has made significant growth in deposit mobilization i.e. 19%, general investment 15%, and operating profit 9%. The Return on Equity (ROE) and Return on Asset (ROA) recorded at 8.78% and 0.66%. The total assets of the bank amounted to BDT 652,422 million (US$ 8.36 Billion) as on December 31, 2014 registering 19% increase over previous year. Equity base of the Bank has increased to stand at BDT 48,570 million at year end 2014 against BDT 45,487 million of the previous year. However, low growth of general investment and non-investment income coupled with surplus liquidity and nonperforming investment resulted in operating profit at BDT 15,323 million. Profit after tax of the Bank was BDT 3,999 million during 2014, and earning per share (EPS) was BDT 2.48 in 2014 compared to BDT 3.07 of the previous year. In spite of that the bank has consolidated its financial strength through maintaining adequacy in capital. The capital adequacy ratio (CAR) of the Bank stood at 12.83% in 2014.

In order to analyze further and get deep into the efficiency and profitability condition of the bank, series of ratio analysis have been conducted.

Table 3: Key Ratio analysis of IBBL

	2014	**2013**
1. ROE	8.78%	12.06%
2. ROA	0.66%	0.98%
3. EM	13.26	12.33
4. Debt/Equity	12.99	11.48
5. Expense ratio	7.91%	8.16%
6. Financing exp. Ratio	5.11%	6.01%
7. Non-financing expense	2.02%	2.15%
8. Financing loss ratio	0.81%	0.60%
9. Financing income ratio	8.20%	9.36%
10. Non-financing income ratio	1.49%	1.57%
11. Expense to income ratio	81.84%	80.11%
12. Profit distribution ratio	62.29%	64.18%

In summary, income statements (Appendix 1) and balance sheet (Appendix 2) of the bank demonstrated mixed performance attributed to improved efficiency due to decrease in all expense ratios, increased investment but decrease in financing and non-financing income. Debt-equity ratio indicates the bank is currently using more debt than equity due to increase in deposit mobilization through its large network branches in Bangladesh. It is noteworthy to mention that expense to income ratio increased over the year and it is mainly due to increase in operational expenses and currently the bank has the largest workforce among the private commercial banks in Bangladesh. In terms of distribution of dividends, generally the profit attributable to *mudaraba* depositors is lower than the shareholders return. In later section, this issue is going to be discussed in details.

It is necessary to incorporate risk exposures of a bank to evaluate its performance objectively as risk exposure may adversely affect the bank's economic capital in case of inappropriate information to make decisions. In this manner, ROA and ROE cannot be used as the only performance measure of a banking firm. A risk adjusted performance measure is necessary as it is critical to the bank (**Rosly, 2014**). Therefore, risk adjusted rate of return (RAROC) of IBBL is being calculated in the following table

Table 4: Risk adjusted rate of return (RAROC) based on Murabaha portfolio

		BDT
	2014[a]	**2014[b]**
1. Murabaha financing portfolio	2,53,91,66,88,852	2,53,91,66,88,852
2. Annual Rate (Income on Murabaha investment)	11.61%	11.61%
3. Murabaha Revenue (1×2)	29,47,97,27,576	29,47,43,02,572
4. Economic capital against financing	12.5%	12.5%
5. Economic capital in BDT (1×4)	31,73,95,86,107	31,73,95,86,107
6. EC Investment @ (Return on Islamic bond)	1.83%	1.83%
7. Return on EC (4×6)	58,14,34,112	58,14,34,112
8. Deposits	2,53,91,66,88,852	2,53,91,66,88,852
9. Income on deposits (profit paid of deposits)	6.11%	6.11%
10. Deposit expense (8×9)	15,51,43,09,689	15,51,43,09,689
11. Expected loss (%)	0.75%	1.75%
12. Expected loss in BDT (1×11)	1,90,43,75,166	4,44,35,42,055
13. Operating expenses (1×2.8%)	7,10,96,67,288	7,10,96,67,288
14. RAROC = (Revenues – Expenses + ROC – EL)/Economic Capital	17.43%	9.43%

[a] Expected loss considered as actual loss reported in 2014, which was 0.75%.
[b] Expected loss assume 1.75% of total murabaha financing
Source: Author's calculation based on Annual Report 2014

From the above illustration RAROC of the *murabaha* portfolio is 17.43% at expected loss of 0.75% (based on current loss to total financing) and 9.43% at expected loss of 1.75% (pessimistic scenario). When RAROC is found to be higher than ROC, the bank will approve the transaction. In our case, RAROC is higher than ROC, i.e., 17.43% > 1.83%. The lower rate of return on economic capital is one of the major impediments for Islamic banks in Bangladesh. This is due to lack of financial instruments for investment with economic capital of a bank, currently, Bangladesh Bank only offers Bangladesh Government Islamic Investment Bond (BGIIB) which rate of return is relatively lower.

Identification and mitigation of Investment risk

Investment risk is concerned with the possibility of financial losses due to counterparties' inability or unwillingness to make contractually-agreed-upon payments. According to the annual report, analyses of banking industry data in Bangladesh indicate that 85% of the total Risk Weighted Asset (RWA) emanated from credit risk while the same was 90% for IBBL. As such, investment risk is key factor of IBBL's risk management framework.

IBBL's Investment Risk Management Policy is approved by the Bank's Board of Directors, which plays a central and strategic role in managing daily business activities. The policy defines the principles encompassing client selection, due diligence, early alert reporting, tolerable levels of concentration risk and portfolio monitoring, in line with the Bank's risk appetite. The approach is to avoid large investment risk on a counterparty or portfolio level by applying stringent standards combined with sound collateralisation where feasible. The policy is reviewed regularly by the Board of Directors and updated throughout the year to ensure consistency with the Bank's business strategy. A monthly Investment Risk Management Committee meeting chaired by the Head of Investment Wing drives policy decisions and implementation plans.

Investment Processing and Approval Structure

IBBL, being the largest investment portfolio-dealing bank of the country, has specific policies in place for inducting, dealing, processing, sanctioning, handling overdue and nonperforming investments of the Bank. The Board of Directors of the Bank delegates sanctioning power from the Board to the Branch Incumbent. The investment approval procedure is being followed in accordance with the approved policy of the Bank. In every approval units i.e. at the Branch, Zone and Head Office level, there is Investment Appraisal Committee which mainly appraise and recommend the proposals.

In order to measure bank's investment risk exposure, we are going to look at the mode wise investment and identify the major types of investment contracts IBBL is currently using.

Table 5: Mode wise investment

		BDT
	2014	% of Total Assets
Bai-Murabaha	2,53,916.69	**54.79**
Bai-Muajjal	29,797.76	**6.43**
Hire Purchase under Shirkatul Melk	1,03,940.76	**22.43**
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Bills Purchased and Discounted	27,381.37	5.91
Total	**4,63,475.47**	**100.00**

Investment Portfolio and Risk Weighted Assets

Islami Bank Bangladesh Limited follows the standardized approach for assessing investment risk and the Risk Based Capital Adequacy Guideline prescribed by Bangladesh Bank. According to the aforesaid guideline, the risk weight categories are 0%, 20%, 40%, 50%, 60%, 75%, 80%, 100%, 125% and 150%.

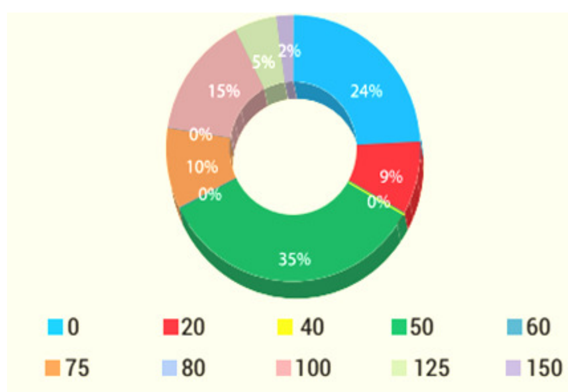


Figure 5: Risk weight-wise exposure

Risk weight wise exposure of the Bank is shown in the figure 5.

It is evident from the graph that around 72% of the exposure of the Bank lies under the Risk weight category of 50% or below, which is considered to be one of the significant strengths of IBBL.

Table 6: Portfolio wise exposure

			BDT
	2013	2014	Increase/Decrease
Total Assets	55,146.78	64,797.85	9,651.07
Total RWA	**28,769.57**	**33,670.14**	**4,900.57**
Efficiency in RWA	52.17%	51.96%	-0.21%
Total Eligible Capital	4,551.19	4856.99	305.8
CAR	**14.26%**	**12.83%**	**-1.43%**
Outstanding against Corporate (on balance sheet+off-balance sheet)	28,576.17	31,225.28	2,649.11
RWA against Corporate (On+Off balance sheet)	**16,728.59**	**18,872.87**	**2,144.28**
Efficiency in Corp RWA	58.54%	60.44%	1.90%
Unrated Corporate	1,984.81	2,805.91	821.1
RWA (Unrated)	2,481.01	3,507.39	1,026.38
Efficiency**	125%	125%	0.00%
Outstanding (past due)	1,838.95	2,329.50	490.55
RWA (past due)	2,163.92	2,712.99	549.07
Efficiency in RWA (past due)	117.67%	116.46%	-1.21%
Others Assets	22,746.85	28,437.16	5,690.31
RWA against Other Assets	2,051.61	1,924.02	(-127.59)
Efficiency in RWA	9.02%	6.77%	-2.25%

*** The risk weight for unrated investment clients is fixed at 125% by RBCA guideline of BB.*

Capital Requirement against Investment Risk

As mentioned earlier, the major portion of RWA arises from investment risk exposure. Out of RWA of BDT 336,701 million against investment risk award 94% emanated from Balance Sheet Exposure. The capital charge against investment risk was BDT 33,670 million.

Table 7: Capital requirements for Investment risk

			As on December 31, 2014 (In million BDT)
	Solo	Consolidated	% of Total Capital Requirement
Capital requirements for Investment risk	**33,670.14**	**33,616.60**	**88.82%**
Capital requirements for Market Risk	639.49	639.49	1.69%
Capital requirements for Operational Risk	3,564.64	3,590.64	9.49%
Total Capital Requirement	**37,874.27**	**37,846.73**	**100.00%**

In order to mitigate investment risks IBBL has taken active measure like, regular investment review, revaluation of securitized assets, and financial performance of the clients. In addition to that, as per regulatory requirements bank maintains provision for investments including bad and doubtful investments. In the following table detailed provisioning for investments are shown.

Table 8: Provision for investments including bad & doubtful investments

		BDT
	2014	2013
General provision		
Unclassified investments excluding OBU	3,30,79,26,000	3,04,15,38,171
Unclassified investments - OBU	12,31,93,000	16,21,34,829
Special mention account	19,43,61,000	16,79,27,000
Sub-total	3,62,54,80,000	3,37,16,00,000
Off-balance sheet items	1,12,82,00,000	1,13,72,00,000
Sub-total (General provision)	4,75,36,80,000	4,50,88,00,000
Specific provision		
Substandard	10,10,45,936	13,03,47,000
Doubtful	25,58,09,525	11,32,65,000
Bad and loss	12,99,78,64,539	8,79,41,88,000
Sub-total (Specific provision)	13,35,47,20,000	9,03,78,00,000
Total provision held at the end of the year	18,10,84,00,000	13,54,66,00,000

On the one hand, it is evident from the above table that general provisioning remained more or less same in 2014 compare to 2013, on other hand, specific provisioning for doubtful investment increased by two times. More worryingly, specific provisioning for bad and loss investment increased by BDT 4203.7 million from 2013 to 2014. All in all, Non Performing Investments (NPIs) creates pressure on the balance sheet as massive capital erosion is evident in case of increasing default in investments which has been growing for overall banking industry.

Financing impairment: Depositors or Shareholders

From the income statement (appendix 1) of IBBL, we can see that, there are no impairment charges to depositors' fund, even though credit exposures using *mudaraba* funds carry credit risk and capital is charged since they are deposit funds but do not carry commercial risk. On the other hand, it is evident that shareholders' fund carry financial risk and commercial risk, consequently, they are under impairment charges. This is exactly the same as in conventional banks operating in Bangladesh where provisions for loan impairment are charged to the bank's earnings only which contradicts the profit and loss sharing principle.

To elaborate further, as per *mudaraba* principle, agreement between the *mudaraba* depositors and the bank, the *mudaraba* depositors are entitled to get minimum 65% of the investment income earned through deployment of *mudaraba* fund as per weightage assigned to each type of *mudaraba* deposit (**IBBL Annual Report, 2014**). In the year 2014, IBBL paid 71.48% of Investment Income earned through deployment of *mudaraba* fund. In some *mudaraba* deposits, additional rate was allowed over the rate derived as per weightage. *Mudaraba* Depositors do not share any income derived from various banking services where their fund is not involved and any income derived from Investing bank's equity and other cost free fund. Al-Wadeeah Depositors do not share any income of the Bank. Profit is paid/provided to *mudaraba* deposit accounts at provisional rate on half yearly/yearly/anniversary basis considering overall projected growth, performance and profitability of the Bank during the year. Final Rates of profit of any accounting year are declared after finalization of *Shari'ah* Inspection report and certifying the Investment Income of the Bank by the statutory auditors.

It is a common practice and industry standard among conventional banks not to financing charge to depositors. However, Islamic banks operating under dual banking system and competing with conventional banks for increasing their deposit base have no other choice but to guarantee the deposit and competitive rate of return in order to avoid displaced commercial risks.

Income from the investment of shareholders' fund

As per Bangladesh Accounting Standard Board (BASB), Islamic banks like conventional banks do not separately report investment shareholders' fund and depositors' fund. Standard income statement of an Islamic bank typically shows income from investment and deducts profit paid to depositors to get the net investment income (see Appendix 1). As per rule and industry practice, shareholders' fund are usually kept in reserve account with Bangladesh Bank, invested in highly liquid and secured investment like government bond or treasury-bills. In Bangladesh, lack of *Shari'ah* compatible instruments force all Islamic banks to hold cash and only recently Bangladesh Bank, the central Bank of Bangladesh, introduced *Shari'ah* compliant Islamic bond, Bangladesh Government Islamic Investment Bond (BGIIB). In addition to that, IBBL also invests its shareholders' fund in *Shari'ah* compliant securities which are considered risky. IBBL only invests only small portion of its' overall shareholders fund and also invested through its two subsidiaries.

Total shareholders fund (shareholders' equity) in 2014 was BDT 46,580 million, IBBL invested BDT 97,435 million in Bangladesh Government Islamic Investment Bond (Table 9) and income derived from this investment was BDT 1784 million (Table 10). This shows that IBBL invested in BGIIB not only its shareholders' fund available but also part of general reserve fund and also short-term depositors fund, in later case, mostly deposit from al-wadiah deposits, as these are safekeeping demand deposit and IBBL are not bound to give any fixed return but can give *hibah* to depositors which is an industry norm as it uses these funds. Moreover, higher liquidity and shorter term indicates lower yield of BGIIB and in 2014 return on investment in BGIIB was 1.83% annually (0.46% quarterly) for total invested fund. From this we can estimate the total return from investors' fund, i.e. Shareholder equity ×Rate of return = BDT 46,580 million×1.83% = BDT 852.41 million. Most importantly, from August 2014 rate of return on BGIIB will be determined on the 3/6 month *mudarba* fixed deposit rates rather than earlier annual profit or loss. In this changing circumstance, earnings from investment of shareholders fund are likely to increase profitability of the bank.

Table 9: Investment in shares and securities

		BDT
	2014	**2013**
i) Government		
Islami Bank Bangladesh Ltd	97,43,57,77,770	63,69,88,77,770
Islami Bank Securities Ltd	-	-
Islami Bank Capital Management Ltd	-	-
Sub total	**97,43,57,77,770**	**63,69,88,77,770**
ii) Others		
Islami Bank Bangladesh Ltd	3,42,07,51,126	3,51,25,21,198
Islami Bank Securities Ltd	1,82,08,10,657	1,88,74,93,659
Islami Bank Capital Management Ltd	-	-
Inter-company balances	-2,99,99,39,000	-2,99,99,39,000
Sub total	**2,24,16,22,783**	**2,40,00,75,857**
Total (i+ii)	**99,67,74,00,553**	**66,09,89,53,627**

Table 10: Income from investments in shares and securities

		BDT
	2014	2013
i. Inside Bangladesh		
Bangladesh Government Islamic Investment Bond (BGIIB)	**1,78,49,15,681**	**2,03,24,12,208**
Bangladesh Shipping Corporation (BSC)	20,00,000	-
Central Depository Bangladesh Ltd (CDBL)	57,11,802	1,46,23,166
Income on Share Securities Trading	22,22,593	4,79,286
Islami Bank Capital Management Ltd	10,49,97,550	-
Other Banks/companies	4,00,776	-
Sub total(i)	**1,90,02,48,402**	**2,04,75,14,660**
ii. Outside Bangladesh	-	-
Sub total(ii)	-	-
Grand total (i+ii)	**1,90,02,48,402**	**2,04,75,14,660**

Return on investment from shareholders fund tends to be lower for Islamic banks in Bangladesh due to lack of *Shari'ah* compliant investible instruments. Currently, BGIIB is the only instrument available and high demand for this instrument among Islamic banks instigates Bangladesh Bank and Securities and Exchange Commission to develop *Shari'ah* compliant financial instruments for ensuring better liquidity management.

Risk associated with Islamic securities bought/held for trading

96.58% of total investment in securities and shares are made on BGIIB (Appendix 3) and rest are invested in IBBL's own subsidiaries which consists of 3% and rest 0.42 % invested in securities of 41 different *Shari'ah* complaint companies, consequently, we do not see any interest bearing conventional banks in the list as well companies which main businesses are not in line with *Shari'ah* namely, alcoholic production, gambling, entertainment media, weapon industries etc.

Table 11: Maturity grouping of investments in shares & securities

		BDT
	2014	2013
Repayable on demand	-	-
With a residual maturity of		
Up to 1 Month	19,35,56,55,126	7,87,00,25,198
Over 1 month but not more than 3 months	**35,46,00,00,000**	**3,11,00,00,000**
Over 3 months but not more than 1 year	**42,61,80,00,000**	**32,23,00,00,000**
Over 1 year but not more than 5 years	30,00,00,000	20,98,00,00,000
More than 5 years	3,12,28,73,770	3,02,13,73,770
Total	1,00,85,65,28,896	67,21,13,98,968

From the above table, we can see that short-term, 1 to 3 months and 3 to 12 months, securities are dominant portion of total investment in shares and securities. It is evident as IBBL invested heavily on short-term securities like BGIIB which are 1 to 3 months and 3 to 6 months in terms of maturity. These investments are highly liquid, indicates IBBL has sufficient fund to fulfill its short-term obligation like deposits withdrawal, paying against LCs, profit to the depositors and dividends to the shareholders.

As there are market risk associated with investments in shares and securities IBBL makes provision for any unexpected loss due to adverse effect in securities value. The following table shows the provisioning made by IBBL during the financial year 2013-2014.

Table 12: Provision for diminution in value of investments in shares

	2014	2013
i) Dealing securities		
Quoted	33,41,661	2,66,778
Un-quoted	-	-
Sub-total (i)	33,41,661	2,66,778
ii) Investment securities		
Quoted	-	-
Un-quoted	1,57,000	1,57,000
Sub-total (ii)	1,57,000	1,57,000
Total (i+ii)	**34,98,661**	**4,23,778**

Physical assets and inventories: Risk associated

Physical assets consist of land, building, furniture and fixtures, computer equipment, motor vehicles, ATMs and others. Significant portion of these assets are common in IBBL's balance sheet as it is one of the largest commercial banks with over 300 branches across Bangladesh. The following table highlights the tangible assets held by IBBL in 2014 and 2013.

Table 13: IBBL's tangible assets

	2014	2013
Land	**7,59,32,66,550**	**7,59,25,98,419**
Building	**6,31,73,93,834**	**6,23,43,91,377**
Construction/ capital work-in-process	19,71,06,998	10,38,12,967
Furniture and fixtures	81,16,88,722	71,93,77,288
Mechanical appliances	**3,09,84,63,563**	**2,72,10,50,008**
Motor vehicles	59,94,38,630	52,51,69,792
ATM	63,28,74,804	48,28,30,169
Books	58,75,956	47,73,584
Total cost of tangible assets including revaluation	**19,25,61,09,057**	**18,38,40,03,604**
Less: Accumulated depreciation	3,60,71,89,972	2,93,46,15,074
Net book value of tangible assets at the end of the year	**15,64,89,19,085**	**15,44,93,88,530**

These items are funded by investors' fund. At startup shareholders provide paid-up capital to establish the bank, i.e, renting office space, furniture and fixtures, and other activities. Later, retained earnings are usually reinvested for further development of the banking facilities and IBBL built its own head office, which is located at a key commercial area in Dhaka city. At present, dominant portion of fixed assets of the bank are coming from land and building which is more 88% of total tangible assets. Accumulated depreciation was BDT 3,607 million for the year 2014.

There are various types of risk associated with tangible assets but market risk is predominant due to fall in value of land and building; operational risk is also high due to failure in mechanical devices such as computer network, banking software and ATM. In addition to that the bank needs to depreciate tangible assets due to wear and tear, which is considered as non-cash expense.

Derivatives in IBBL

IBBL has no investment in any derivative instruments. Basically there are no derivative instruments available in Bangladesh financial market at the moment. Therefore, it is not only Islamic banks that cannot use such derivative instruments as forward, futures and swaps which are based on *Shari'ah* compliant underlying assets and necessary for hedging purposes. AAOIFI has not issued any standard for derivatives as the issue is still controversial and there is no consensus among *Shari'ah* scholars, however, the SAC of SC and BNM of Malaysia has approved certain types of derivative instruments like commodity futures (Crude Palm Oil futures), *wa'd* based currency forward, composite index futures and single stock futures. Even though many argue and criticize complicated derivative instruments like Credit Default Swaps (CDSs) for 2007/08 global financial crisis, but the importance of derivative instruments for risk management purpose is undoubtedly vital as players in financial markets and development of Islamic finance (**Obiyathullah, 1999**). As many argue derivative instruments can be used to mitigate various types of risks face by IFIs: commodity risk, foreign exchange risk, profit rate risk and so on, where derivative instruments like currency forward, profit rate swap, commodity futures can play a vital role.

Income gap analysis

In our previous sections we have discussed various types of risks associated with Islami Bank Bangladesh Ltd. One of the key risks that many Islamic banks face is mismatch in variable rate assets and variable rate liabilities. This imposes a great threat to the earning potentials of Islami bank. The inherent structure of Islamic bank tends to have higher variable rate liabilities than assets. In the following table we show the income gap analysis for Islami Bank Bangladesh Ltd.

From the analysis of IBBL balance sheet, we have observed that fixed rate finance (FRF) constitutes the dominant portion of Islamic banking financing as evidenced in many murabaha, *bai-al-muajjal* ad HPSM contracts. On the other hand, variable rate deposits (VRL), mostly *al-wadiah* and *mudarbah* deposits remain high as theoretically Islamic bank cannot give guarantee on fixed rate earnings. In this circumstance, although inter-bank offer rate and subsequently base lending rate (BLR) changed, *murabaha, muajjal* and *HPSM* profit rates cannot be changed accordingly. This imposes a great threat to Islamic bank's earnings capacity in increasing interest rate environment.

Table 14: Income gap analysis of IBBL

				As on December 31, 2014
				BDT in million
	1-90 days	Over 3 months to 6 months	Over 6 months to 9 months	Over 9 months to 12 months
Rate Sensitive Assets	1,10,619.68	61,780.38	76,192.23	77,087.72
Rate Sensitive Liabilities	1,05,740.27	60,812.00	75,306.78	76,685.80
GAP	4,879.40	968.37	885.45	401.92
Cumulative GAP	4,879.40	5,847.78	6,733.22	7,135.15
Adjusted profit rate changes (PRC)	0.50%	0.50%	0.50%	0.50%
Quarterly earnings impact (Cum.Gap*PRC)	6.10	7.31	8.42	8.92
Accumulate earning impact to date	6.10	13.41	21.83	30.74

However, in case of IBBL, we observed that rate sensitive assets are higher than rate sensitive liabilities (VRA□VRL), i.e. a Positive income Gap which is unfavorable for the Islamic and conventional banks in current decreasing interest rate/profit rate environment in Bangladesh. Evidently we found cost of fund for IBBL decreased to 8.55% in 2014 from 9.45% in 2013.

In other words, a decrease in profit rate will reduce income on *murabaha* financing (fixed rate financing) as much as the cost of funds and vice-versa. Consequently, net income earnings will decrease in downward interest rate/profit rate scenario. For example, 50 basis points decrease in the level of interest rate would decrease the profit by BDT 30.74 million and vice-versa for increase in the level of interest rate/profit rate. However, it can be further argued that, in the recent past as decreasing interest-rate trend has significantly affected earnings of IBBL, for example, ROA and ROE has dropped from 19% and 1.47% in 2014 from 9% and 0.67% in 2010 respectively. Consequently, at the same time period, EPS has declined to BDT 2.48 from BDT 6.02. It can be argued that dual banking system, central bank policy and money market instruments undoubtedly favor conventional banks, consequently, Islamic banks mimic them. Therefore, positive income gap in IBBL and other Islamic banks in Bangladesh is market driven but this strategy do not suit well for Islamic banks as they heavily rely on fixed rate financing and floating rate deposits.

Risk weighted assets and regulatory capital

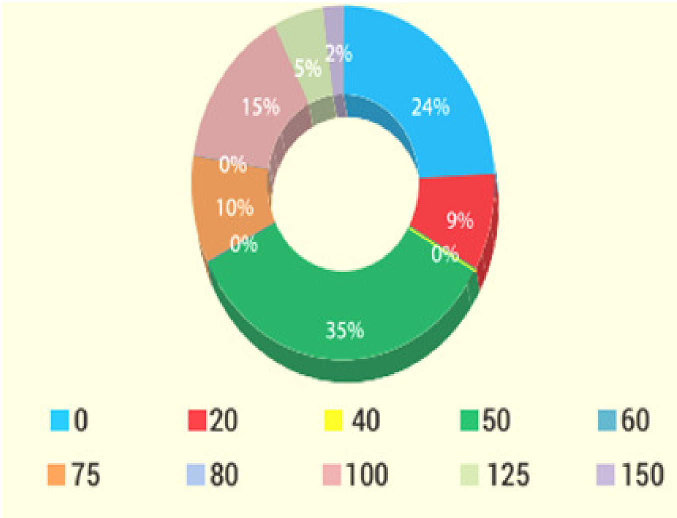
Fractional reserve system gives banks the ultimate leverage to borrow and lend multiply times of its core capital provided by shareholders and investors. But the global financial crisis has changed the scenario of financial sectors more specifically banking industry. Local and international regulators like central banks as well as international organization like Bank for International Settlements (BIS) have come up with many prudential and regulatory requirements like Basel accord I and II, and finally III. As banking business deals with various risks, it is necessary to have cautionary measures like assigning risk weights for various types of investments and also minimum capital required to keep aside for expected or unexpected losses. In the table below, mode wise investment exposure of IBBL in shown.

Table 15: Mode wise investment exposure

	2014		**2013**	
	Amount	% of Total Investment	Amount	% of Total Investment
Bai-Murabaha	**2,81,556**	**60.75%**	**2,24,456**	**55.17%**
HPSM	**1,09,941**	**23.72%**	**95,491**	**23.47%**
Bai Muajjal	**15,443**	**3.33%**	**23,103**	**5.68%**
Bill Purchased & Negotiation	30,424	6.56%	23,261	6.61%
Quard	15,478	3.34%	13,670	3.36%
Bai- Salam	4,808	1.04%	3,889	0.96%
Mudaraba	**3,000**	**0.65%**	**-**	**0.00%**
Musharaka	**2,825**	**0.61%**	**19,323**	**4.75%**
Total	**4,63,475**	**100%**	**4,03,195**	**100%**

If we compare, IBBL overall mode-wise investment exposure has not changed radically except 5.58% increase in *bai-murabaha* and 4.14 decrease in *musharaka*. These changes indicate that the bank is moving towards less risky investment portfolio from risky investment. This risk-averse attitude and diversion from true profit and loss sharing contracts like *mudaraba* and *musharaka* may raise question like rent seeking activity of Islamic banks (**Suzuki & Soharb, 2014**).

Investment Portfolio and Risk Weighted Assets



Islami Bank Bangladesh Limited follows the standardized approach for assessing investment risk and the Risk Based Capital Adequacy Guideline prescribed by Bangladesh Bank. According to the aforesaid guideline, the risk weight categories are 0%, 20%, 40%, 50%, 60%, 75%, 80%, 100%, 125% and 150%. It is evident from the graph that around 72% of the exposure of the Bank lies under the Risk weight category of 50% or below, which is considered to be one of the significant strengths of IBBL.

Table 16: Regulatory capital requirement of IBBL

	As on December 31, 2014 (in Million BDT)	
	Solo	Consolidated
A. Tier-I (Core Capital)		
i. Fully paid-up Capital	16,099.91	16,099.91
ii. Statutory Reserve	16,099.91	16,099.91
iii. Non-repayable Share Premium account	1.99	1.99
iv. General Reserve	377.16	377.16
v. Retained Earnings	2,414.97	2,386.66
vi. Minority interest in Subsidiaries		0.06
vii. Non-cumulative irredeemable preference shares	-	-
viii. Dividend equalization account	32	32
ix. Other (if any item approved by Bangladesh Bank)	-	-
Sub-Total (Core Capital) A (i to ix)	**35,025.95**	**34,997.69**
B. Tier 2 and Tier 3 capital		
i. Tier 2 capital	13,543.92	13,543.92
ii. Tier-3 (Eligible for market risk only)	-	-
Sub Total (Supplementary Capital) B (i+ii)	**13,543.92**	**13,543.92**
a) Other deductions from capital	-	-
C Total Eligible Capital (A+B)	**48,569.86**	**48,541.61**

The Bank has adopted Standardized Approach (SA) for computation of capital charge for investment risk and market risk, and Basic Indicator Approach (BIA) for operational risk. Assessment of capital adequacy is carried out in conjunction with the capital adequacy reporting to Bangladesh Bank. The Bank has maintained capital adequacy ratio at 12.83% & 12.83% on the basis of "Consolidated" and "Solo" respectively as against the minimum regulatory requirement of 10%. Tier-I capital adequacy ratio under "Consolidated" basis is 9.25% and "Solo" basis is 9.25% as against the minimum regulatory requirement of 5.00%. The Bank's policy is to manage and maintain strong Capital Adequacy Ratio through investing high rating grade investment clients. The Bank maintains adequate capital that is sufficient to absorb all material risks associated with the Bank. The Bank also ensures that the levels of capital comply with regulatory requirements and satisfy the external rating agencies and other all stakeholders including depositors.

Market and operational risk

Market Risk

IBBL adopted Standardized Approach and follows the Risk Based Capital Adequacy Guidelines issued by Bangladesh Bank for assessing the Market Risk. There are four components from which Market Risks are evolved. The components are as under: a) Profit/Interest Rate Related Instruments, b) Equities, c) Foreign Exchange Position, and d) Commodity Risk.

Being a *Shari'ah* based bank, IBBL does not deal with any profit/interest related instruments and purchases goods/ commodities from the seller and simultaneously sell the same to the ultimate buyer. IBBL does not hold the goods/commodities as owner of the same at any stage. As such, IBBL has no exposure under these components. The Market Risk Exposure of IBBL has been shown in Pillar-III Disclosure under Basel-II part of the annual report.

Operational Risk

Operational Risk is the potential loss arising from breakdown in Bank's systems & procedures and corporate governance practices that results in human error, fraud, failure, damage of reputation, delay to perform or compromise of the Bank's interest by employees.

IBBL follows Basic Indicator Approach for assessing the Operational risks. Under this approach, average of the Gross Incomes of last three years is taken as the proxy for operational risks. The average gross income for the last three years was BDT23,764 million. Therefore, the capital charge against Operational Risk is BDT 3564.64 million (15% of the average Gross Income).

Table 17: Capital requirements for market and operational risk under Basel II

			As on December 31, 2014 (In million BDT)
	Solo	Consolidated	% of Total Capital Requirement
Capital requirements for Investment risk	33,670.14	33,616.60	88.82%
Capital requirements for Market Risk	**639.49**	**639.49**	**1.69%**
Capital requirements for Operational Risk	**3,564.64**	**3,590.64**	**9.49%**
Total Capital Requirement	37,874.27	37,846.73	100.00%

Based on the IBBL's investment exposure, under Basel II accord, capital requirements for market and operational risk is only 1.69% and 9.49% of total capital requirement. In the following table it is shown that foreign exchange risk (96.83%) and equity risk (3.17%) are the main components of market risk. The details break down for operational risk is not found in the market disclosure under Basel II. *Shari'ah risk* can be considered as a major component of operational risks, and IBBL has been striving forward to maintain *Shari'ah* compliance as it is the first and leading not only Islamic bank but also the largest private commercial bank.

Table 18: Total capital requirement for different market risks

			As on December 31, 2014 (In million BDT)
	Solo	Consolidated	% of Total Capital Requirement
Profit (Interest) rate risk	-		
Equity position risk	20.30	20.30	3.17%
Foreign exchange risk	**619.19**	**619.19**	**96.83%**
Commodity risk.	-	-	
Total Capital Requirement	**639.49**	**639.49**	**100.00%**

Other risks of IBBL

Being the *Shari'ah* based bank, IBBL may also face the following specific risks due to its operations in addition to the usual risks:

a) **Fiduciary Risk:** Where *mudaraba* depositors' funds are commingled with the banks own funds, the bank shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the Bank's fiduciary responsibilities.

b) ***Shari'ah* Compliance Risk:** IBBL is always stringent about compliance *Shari'ah* rules in all of its operations. Since IBBL is performing in the mixed economic system (i.e., Islamic and Interest Based economy), *Shari'ah* compliance is the one of the vital factors particularly for IBBL. The independent *Shari'ah* Board keeps keen observations on the day to day transactions of the Bank and they declare doubtful transactions as suspended. Ahmed and Khatun (2013) study the *Shari'ah* compliance of Islamic banks in Bangladesh.

Table 19: *Shari'ah* compliance level of Islamic banks in Bangladesh

		Compliance level of the banks								
AAOIFI Standard No.	Required Issues in Standard (No.)	IBBL (No.)	SIBL (No.)	SJIBL (No.)	EXIM (No.)	ICBI (No.)	AIBL (No.)	FSIBL (No.)	Mean	Standard Deviation
1	5	5	5	4	4	5	4	5	4.57	0.53
2	3	3	3	3	3	3	3	3	3.00	0.00
3	6	6	6	6	6	5	5	6	5.71	0.49
4	2	0	0	0	0	0	0	0	0.00	0.00
5	2	2	2	2	2	2	2	2	2.00	0.00
Total Compliance (No.)	18	16	16	15	15	15	14	16	15.29	0.76
Compliance %		89	89	83	83	83	78	89	85	4

Source: Ahmed & Khatun (2013) p.187

c) **Revenue, gains, expenses & losses prohibited by *Shari'ah***: Doubtful income which is prohibited by *Shari'ah* due to lapses in compliance of *Shari'ah* principles for investment as per *Shari'ah* Supervisory Committee report is included in the investment income of the Bank and appropriate amount of corporate tax is paid on it accordingly on these whole amount whether realized or not. It is not distributed to either depositors or shareholders of the Bank rather the amount net of corporate tax is transferred to an account titled "Doubtful income account' under other liabilities of the Bank. Only realized amount of doubtful income (on which corporate tax has already been paid due to inclusion in investment income) is then expended for charitable purposes. Total doubtful income in 2014 was 0.203% of total investment income of BDT 4,910 million.

Bank charges compensation on overdue investments under Bai-modes. The total amount of compensation is not included in investment income rather kept separately under other liabilities. However, tax on this amount duly considered. Realized amount of compensation (on which corporate tax has already been paid due to inclusion in investment income) are expended for charitable purposes.

Interest received from the balances held with foreign banks and from foreign currency clearing account with Bangladesh Bank are not credited to income, since it is not permissible as per *Shari'ah*. These are expended for charitable purposes after payment of corporate income tax thereon.

Table 20: Provision for doubtful income account

	2014	**2013**
Opening balance	-	-
Add: Provision made during the year	10,33,60,602	-
Less: Expended for charitable purposes	3,22,03,475	-
Closing balance	7,11,57,127	-

d) **Displaced Commercial Risk:** Banks may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by the *mudaraba* depositors when the return on assets is under performing as compared with the competitors' rates. In such case, banks may decide to waive their rights to part or its entire *mudarib* share of profits in order to satisfy and retain its fund providers and dissuade them from withdrawing their funds.

e) **Excess Liquidity risk in IBBL for lack of non-structured Islamic Financial Market:** As discussed in the previous section, since, Islamic Financial Market in

Bangladesh is not strong enough and there is inadequate Islamic financial instruments, IBBL has limited scope for placement of fund with the desired return from the market at the time of surplus liquidity and similarly limited scope in receiving fund complying *Shari'ah* rules at the time of liquidity crisis. However, during the long 31 years of banking operations, IBBL did not face any liquidity crisis since it remains vigilant enough to address the issue.

Table 21: Liquidity risk and industry comparison

Islamic Banks	Y-O-Y growth TD(%)	Y-O-Y growth cost of fund (%)	Growth in Net Profit after Tax	CSTA/TA	MTD/TD
IBBL	18.51%	-9.52%	-19.19	10.72	30.19
SJIBL	2.20%	-11.24%	-42.76	12.45	46.22
SIBL	21.97%	-14.50%	56.02	9.79	60.51
FSIBL	30.81%	-0.25%	-15.58	8.24	67.04
AIBL	18.35%	-1.54%	2.12	11.83	59.42
EXIM	20.85%	-12.63%	29.66	13.77	61.52
ICBI	0.38%	-5.68%	-57.91	8.50	84.10
Union	185.79%	58.87%	84.92	23.75	86.76
Industry Average	**37.36%**	**0.44%**	**4.66**	**12.38**	**61.97**

Source: Author's own calculation based on Annual reports of 8 full-fledged Islamic banks for 2014

IBBL has MTD/TD at 30.19%, the lowest among all Islamic banks in Bangladesh which explains somewhat proportional increase in the growth of deposits but decrease in cost of funds at 18.51% and 9.52% respectively. This has produced decrease of net profit at 19.19% even though IBBL held lower cash and short-term assets compare to industry players. Decreasing interest rate environment in Bangladesh for last couple of years gave edge on both asset and liability sides of IBBL its asset side is dominated by fixed-rate murabaha financing while liability side is dominated by floating rate *mudaraba* deposits.

f) **IBBL's equity price risk:** IBBL is a listed company in Dhaka Stock Exchange and Chittagong Stock Exchange. Efficient market hypothesis assume market price reflect the fundamental value of the company, that's why, it is necessary to study the equity price of IBBL to have an idea about investors' perception and potential of the bank. The following graph shows the stock performance of IBBL in 2014.

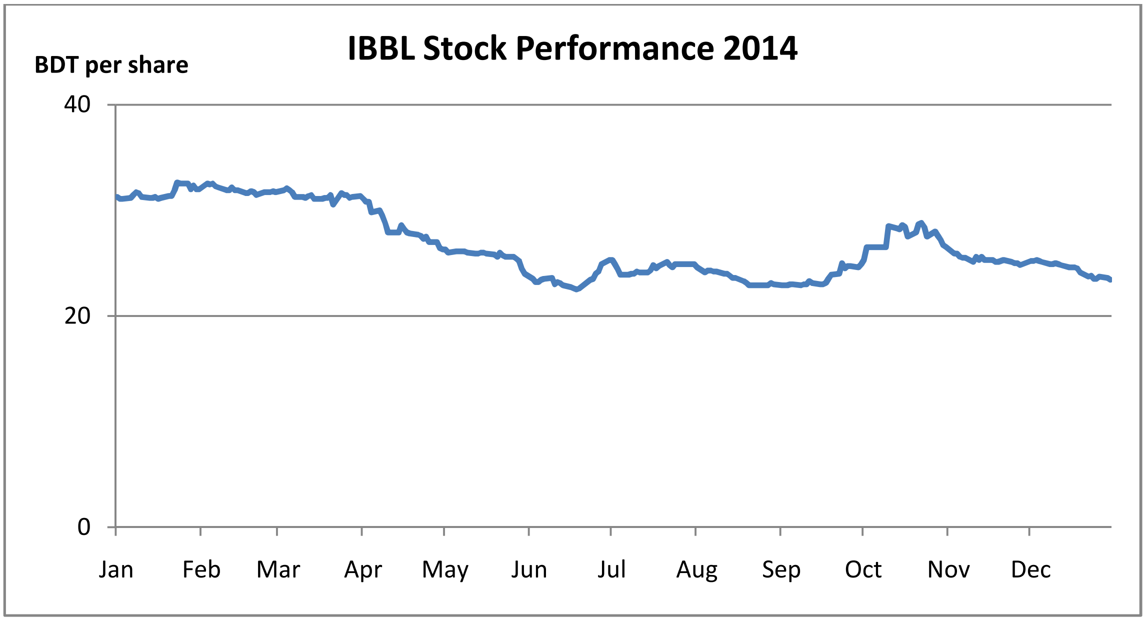


Figure 6: IBBL stock performance 2014 (Daily data from Datastream)

Table 22: Performance of IBBL in stock market compare to major market players

	Average Share Price	Mean Return	Stdev	Yearly (+/-)
IBBL	26.754368	-0.043%	0.839%	-25.17%
FSIBL	11.182682	-0.056%	1.095%	-28.48%
SIBL	12.263678	-0.039%	1.190%	-21.65%

The above graph and table show that IBBL stock has performed relatively well in a highly volatile stock market in 2014. If we compare with other industry peers, we would see that prices of all banking companies have decreased.

Conclusion

The phenomenal growth of Islamic banking industry has forced regulators, industry players and academics to take comprehensive look at overall structure of Islamic bank risks associated with it. Risk is inherent in banking business as bank act as an intermediary between surplus and deficit unit in a financial system. Frictional reserve mechanism gives excessive leverage to bank to raise fund and invest multiple times against minimum core capital requirement. Based on this principle, bank usually borrow short/long and invest short/long defending on the interest rate environment and other key macroeconomic variables. The study shows that Islamic banks inherently rely on too much fixed rate financing like *murabaha* due to lower risks associated which are predominately collected from floating rate *mudaraba* deposits. By nature there are various types of risk emanating from existing Islamic banking practices. In this paper, a comprehensive analysis of risk management practices in Islami Bank Bangladesh has been discussed. Islami Bank Bangladesh Limited is the largest and leading Islamic bank among eight full-fledged Islamic banks. It is found that the bank has an extensive risk management framework and process from the top to the bottom. The analysis of bank's financial statements shows that the risk appetite is moderate to low and it is reflected on their risk management framework and process. Financial scorecard confirms that the bank is efficient in generating sustainable earnings from depositors fund but lower return on shareholder's fund due to lack of *shari'ah* compliant financial instruments. Even though the bank mobilize funds on profit and loss sharing principle, but study observes that all risks are actually borne by the bank e.g., financing impairment are charged to shareholders only. It is found that the bank also invest very small portion of its shareholders' fund in securities of nearly 40 different companies, consequently very little risk associated with but covered with provision made against market risk. Physical assets constitute a significant portion of the bank's balance sheet and evidently these assets are funded by shareholders fund. Currently, the bank does not use any derivative instruments as they are not available in the financial market of Bangladesh. Income gap analysis of the bank shows that its rate sensitive assets are higher than rate sensitive liabilities which seem not favorable in decreasing interest rate environment. The spread between funding cost and financing income is above 5%. The inclination towards *murabaha* financing is evident from the analysis and 72% of the exposure of the Bank lies under the Risk weight category of 50% or below, which is considered to be one of the significant strengths of IBBL. The bank has been maintaining healthy CAR for last five years which was well above the minimum requirements. The bank also faces other risks namely, fiduciary risk, displaced commercial risk, *shari'ah non*-compliance risk, excess liquidity risk and equity price risk. Displaced commercial risk and excess liquidity risk tend to affect significantly the bank's efficiency and profitability. It can be concluded that risk management is not a project but a process, therefore, a comprehensive risk management framework and process is the order of the day for sustainability of financial industry more importantly Islamic banking industry.

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Appendix

Appendix 1: Income statement of IBBL

			BDT
Operating income	**2014**	**2013**	**2012**
Investment income	49,10,99,56,379	48,14,54,64,380	43,67,22,25,981
Profit paid on mudaraba deposits	-30,59,29,37,508	-30,90,02,79,562	-25,87,04,25,237
Net investment income	18,51,70,18,871	17,24,51,84,818	17,80,18,00,744
Income from investment in S &S	1,84,72,41,058	2,11,20,29,193	48,43,61,836
Commission	5,88,33,32,280	4,97,86,58,614	5,26,06,47,661
Other operating income	1,22,33,73,942	98,58,19,291	1,12,21,69,884
Total operating income	27,47,09,66,151	25,32,16,91,916	24,66,89,80,125
Operating expense			
Salary and allowance	8,19,75,68,114	7,55,27,61,347	5,96,14,21,881
Rent, taxes, insurance electricity et	1,00,00,45,580	82,51,30,483	65,55,76,460
Legal expenses	1,62,06,043	3,52,85,323	1,34,79,293
Postae	4,73,06,134	4,45,36,896	11,15,28,843
Stationery,	31,76,12,092	33,00,98,889	26,77,30,060
Chief ex. Salary	84,00,000	73,23,548	52,80,000
Directors' fee	1,31,83,767	1,18,75,334	1,00,66,840
Shari'ah committee fee	25,62,124	14,01,423	25,84,829
Auditors' fee	23,44,118	21,68,000	21,68,000
Charges on investment loss	-	-	losses
Depreciation	86,65,06,137	72,99,87,642	50,44,41,086
Zakat	42,59,85,241	38,57,50,934	32,47,72,772
Other expense	1,20,55,50,108	1,13,86,21,359	1,02,97,10,622
Total operating expenses	12,10,32,69,458	11,06,49,41,178	8,88,87,60,686
Profit/loss before provision	15,36,76,96,693	14,25,67,50,738	15,78,02,19,439
Provision for ivestment	4,67,07,84,729	3,01,56,33,502	3,50,26,25,602
Provision for diminutino	3,61,84,361	4,56,27,899	3,09,69,670
Other provision	11,70,49,502	1,32,01,000	94,41,066
Total provision	4,82,40,18,592	3,07,44,62,401	3,54,30,36,338
Total profit/loss befor taxes	10,54,36,78,101	11,18,22,88,337	12,23,71,83,101
Provision for taxation			
Current tax	6,36,73,68,688	6,19,59,69,079	6,57,44,64,832
Deferred tax	20,88,92,553	-4,44,39,537	4,59,64,788
Net profit/loss after tax	3,96,74,16,860	5,03,07,58,795	5,61,67,53,481
Net profit after tax attributable	3,96,74,16,860	5,03,07,58,795	5,61,67,53,481
Equity holders	3,96,74,15,282	5,03,07,57,057	5,61,67,51,549
Non-controlling interest	1,578	1,738	1,932
Retained earning	2,63,78,58,071	3,07,34,02,299	3,01,59,52,005
Add: net profit after tax (a	3,96,74,15,282	5,03,07,57,057	5,61,67,51,549

Profit available for appropriation	6,60,52,73,353	8,10,41,59,356	8,63,27,03,554
Appropriation:	6,60,52,73,353	8,10,41,59,356	8,63,27,03,554
Statutory reserve	1,46,12,93,053	2,21,49,51,285	2,41,92,35,534
General reserve	12,27,79,553	12,39,40,000	-2,22,05,793
Dividend	2,63,45,30,184	3,12,74,10,000	3,20,24,67,840
Retained earnings	2,38,66,70,563	2,63,78,58,071	3,03,32,05,973
Consolidated earnings per share	2.46	3.12	4.49

Appendix 2: Consolidated Balance Sheet of IBBL

			BDT
Property and assets	**2014**	**2013**	**2012**
Cash in hand	46,21,93,59,839	44,29,15,23,619	41,77,40,12,643
Cash in hand (incl. foreign currency)	7,69,68,44,962	8,18,03,46,965	6,30,82,74,680
Balance with BB & agents bank incl FC	38,52,25,14,877	36,11,11,76,654	35,46,57,37,963
Balance with other banks & financl. Insts	23,61,52,18,198	12,70,01,16,779	24,52,49,33,077
In Bangladesh	21,20,58,95,651	7,95,07,37,265	17,43,25,61,802
Outside Bangladesh	2,40,93,22,547	4,74,93,79,514	7,09,23,71,275
Placement with banks & other financl. Inst	2,00,00,00,000	-	-
Investments in shares and securities	99,67,74,00,553	66,09,89,53,627	25,56,00,64,458
Government	97,43,57,77,770	63,69,88,77,770	23,50,49,77,770
Others	2,24,16,22,783	2,40,00,75,857	2,05,50,86,688
Investments	4,60,38,54,67,466	4,02,99,48,04,977	3,72,92,07,22,887
General investments et	4,33,00,41,01,205	3,75,00,02,98,497	3,40,47,97,56,413
Bills purchased & discounted	27,38,13,66,261	27,99,45,06,480	32,44,09,66,474
Fixed assets including premises	15,93,04,79,589	15,73,88,58,683	14,81,67,65,447
Other assets	3,75,15,58,076	4,54,51,07,670	3,05,29,92,955
Non-banking assets	-	-	-
Total property and assets	6,51,57,94,83,721	5,46,36,93,65,355	4,82,64,94,91,467
Liabilities and capital			-
Liabilities			
Placement from banks & other fin. inst	7,65,75,00,743	-	-
Deposits & other accounts	5,59,71,35,80,029	4,72,12,19,71,348	4,17,84,56,88,579
Mudaraba savings deposits	1,83,12,59,42,453	1,55,19,16,05,056	1,51,01,22,62,458
Mudaraba term depsosits	1,69,28,89,34,029	1,30,52,33,71,328	97,27,85,42,378
Other mudaraba deposits	1,49,30,09,04,194	1,30,27,65,10,230	1,17,80,71,37,348
Al-wadeeah current & other a/c	54,34,79,05,252	52,00,08,26,777	47,53,17,08,061
Bills payable	3,64,98,94,101	4,12,96,57,957	4,21,60,38,334
Mudaraba perpetual bond	3,00,00,00,000	3,00,00,00,000	3,00,00,00,000
Other liabilities	34,22,07,63,730	27,28,91,34,160	21,90,38,09,274
Deferred tax liabilities	40,30,81,867	19,41,89,314	23,86,28,851
Total liabilities	**6,04,99,49,26,369**	**5,02,60,52,94,822**	4,42,98,81,26,704
Capital/shareholders's equity	**46,58,45,57,352**	**43,76,40,70,533**	**39,66,13,64,763**
Paid-up capital	16,09,99,06,680	14,63,62,78,800	12,50,96,40,000
Statutory reserve	16,09,99,06,680	14,63,86,13,627	12,42,36,62,342
Other reserves	11,99,80,12,969	11,85,12,58,703	11,69,47,97,161
Retained earnings	2,38,66,70,563	2,63,78,58,071	3,03,32,05,973
Non-controlling interest	60,460	61,332	59,287
Total liabilities & shareholder's equity	6,51,57,94,83,721	5,46,36,93,65,355	4,82,64,94,91,467

Appendix 3: Securities bought/held for trading

	No. of Share	Book value as at 31 Dec. 2014	Book value ast at 31 Dec. 2013	Remarks
Government				
Bangladesh Shipping Corporation	2,00,000	10,15,00,000	8,26,00,000	Quoted
Karmasangsthan Bank	1,00,000	1,00,00,000	1,00,00,000	Un-Quoted
Central Depository Bangladesh Ltd.	22,84,721	62,77,770	62,77,770	Un-Quoted
Bangladesh Government Islamic Investment Bond (Islamic Bond)	34	97,31,80,00,000	63,60,00,00,000	Un-Quoted
Total government	25,84,755	97,43,57,77,770	63,69,88,77,770	
Other than Government				
i) Subsidiary companies				
Islami Bank Securities Ltd	26,99,946	2,69,99,46,000	2,69,99,46,000	Un-Quoted
Islami Bank Capital Management Ltd.	2,99,993	29,99,93,000	29,99,93,000	Un-Quoted
Sub total	29,99,939	2,99,99,39,000	2,99,99,39,000	
ii) Others				
Bangladesh Aroma Tea Ltd.	1,570	1,57,000	1,57,000	De-listed
Investment in Financial Institutions & Investors Portfolio Management Co. Ltd.	5,00,000	50,00,000	50,00,000	Un-Quoted
***Mudaraba* Subordinated Debt of First Security Islami Bank Ltd.**	800	40,00,00,000	50,00,00,000	Un-Quoted
Al-Arafah Islami Bank Ltd.	25,500	3,85,139	-	Quoted
Exim Bank Ltd.	21,635	2,41,263	-	Quoted
Ibn Sina Pharmaceutical Ltd.	3,500	3,65,806	9,18,984	Quoted
Shahjalal Islami Bank Ltd.	17,028	1,93,512	-	Quoted
United Airways (BD) Ltd.	61,600	7,66,413	62,359	Quoted
Fareast Islami Life Insurance Co. Ltd	20,000	20,33,763	6,90,156	Quoted
Power Grid Company of Bangladesh Ltd.	4,000	1,61,302	4,22,512	Quoted
Takaful Islami Insurance Ltd.	24,000	7,16,641	4,17,491	Quoted
Apex Tannery Ltd.	250	35,407	-	Quoted
Prime Textile Ltd.	10,000	1,89,272	-	Quoted
Summit Power Ltd	2,000	76,190	-	Quoted
Confience Cement	15,000	19,73,817	-	Quoted
Premier Cement Mills Limited	25,000	24,40,893	-	Quoted
Apex Foods Ltd.	1,000	99,518	-	Quoted
Meghna Petroleum Ltd.	13,450	34,23,868	-	Quoted
Tallu Spinning Ltd.	55,000	19,06,378	-	Quoted

Meghna Cement Ltd.	500	62,155	-	Quoted
Social Islami Bank Limited.	20,000	2,75,859	-	Quoted
AMCL(Pran)	550	1,08,733	-	Quoted
Rangpur Foundry	2,000	1,99,197	-	Quoted
Khulna power Company Ltd.	-	-	7,01,946	Quoted
ICB Islamic Mutual Fund	-	-	3,91,928	Quoted
BEXIMCO	-	-	3,40,350	Quoted
Square Textile	-	-	10,98,139	Quoted
Titas Gas Company Ltd	-	-	23,81,332	Quoted
Sub total (ii)	8,24,383	42,08,12,126	51,25,82,198	
Sub total Other than Government (i+ii)	38,24,322	3,42,07,51,126	3,51,25,21,198	
Grand Total	**64,09,077**	**1,00,85,65,28,896**	**67,21,13,98,968**	